

## Auditing Procedures Report

Issued under P.A. 2 of 1968, as amended and P.A. 71 of 1919, as amended.

Local Unit of Government Type <input type="checkbox"/> County <input type="checkbox"/> City <input type="checkbox"/> Twp <input type="checkbox"/> Village <input checked="" type="checkbox"/> Other		Local Unit Name John Tolfree Health System	County Ogemaw
Fiscal Year End 3/31/2006	Opinion Date 5/10/2006	Date Audit Report Submitted to State 6/27/2006	

We affirm that:

We are certified public accountants licensed to practice in Michigan.

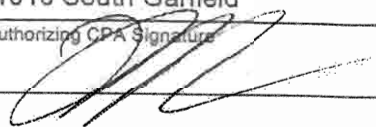
We further affirm the following material, "no" responses have been disclosed in the financial statements, including the notes, or in the Management Letter (report of comments and recommendations).

YES NO **Check each applicable box below.** (See instructions for further detail.)

1. ☒ ☐ All required component units/funds/agencies of the local unit are included in the financial statements and/or disclosed in the reporting entity notes to the financial statements as necessary.
2. ☒ ☐ There are no accumulated deficits in one or more of this unit's unreserved fund balances/unrestricted net assets (P.A. 275 of 1980) or the local unit has not exceeded its budget for expenditures.
3. ☒ ☐ The local unit is in compliance with the Uniform Chart of Accounts issued by the Department of Treasury.
4. ☒ ☐ The local unit has adopted a budget for all required funds.
5. ☒ ☐ A public hearing on the budget was held in accordance with State statute.
6. ☒ ☐ The local unit has not violated the Municipal Finance Act, an order issued under the Emergency Municipal Loan Act, or other guidance as issued by the Local Audit and Finance Division.
7. ☒ ☐ The local unit has not been delinquent in distributing tax revenues that were collected for another taxing unit.
8. ☐ ☒ The local unit only holds deposits/investments that comply with statutory requirements.
9. ☒ ☐ The local unit has no illegal or unauthorized expenditures that came to our attention as defined in the *Bulletin for Audits of Local Units of Government in Michigan*, as revised (see Appendix H of Bulletin).
10. ☒ ☐ There are no indications of defalcation, fraud or embezzlement, which came to our attention during the course of our audit that have not been previously communicated to the Local Audit and Finance Division (LAFD). If there is such activity that has not been communicated, please submit a separate report under separate cover.
11. ☒ ☐ The local unit is free of repeated comments from previous years.
12. ☒ ☐ The audit opinion is UNQUALIFIED.
13. ☒ ☐ The local unit has complied with GASB 34 or GASB 34 as modified by MCGAA Statement #7 and other generally accepted accounting principles (GAAP).
14. ☒ ☐ The board or council approves all invoices prior to payment as required by charter or statute.
15. ☒ ☐ To our knowledge, bank reconciliations that were reviewed were performed timely.

If a local unit of government (authorities and commissions included) is operating within the boundaries of the audited entity and is not included in this or any other audit report, nor do they obtain a stand-alone audit, please enclose the name(s), address(es), and a description(s) of the authority and/or commission.

I, the undersigned, certify that this statement is complete and accurate in all respects.

<b>We have enclosed the following:</b>	Enclosed	Not Required (enter a brief justification)	
Financial Statements	<input checked="" type="checkbox"/>		
The letter of Comments and Recommendations	<input checked="" type="checkbox"/>		
Other (Describe)	<input type="checkbox"/>		
Certified Public Accountant (Firm Name) Plante & Moran, PLLC		Telephone Number 231-947-7800	
Street Address 1010 South Garfield		City Traverse City	State MI
Zip 49686			
Authorizing CPA Signature 		Printed Name Michael A Baker	License Number 1101017229

# **John Tolfree Health System Corporation**

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**Financial Report  
with Additional Information  
March 31, 2006**

# John Tolfree Health System Corporation

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## Contents

<b>Report Letter</b>	1-2
<b>Financial Statements</b>	
Balance Sheet	3
Statement of Revenue, Expenses, and Changes in Net Assets	4
Statement of Cash Flows	5-6
Notes to Financial Statements	7-21
<b>Additional Information</b>	22
<b>Report Letter</b>	23
Combining Balance Sheet	24
Combining Statement of Revenue, Expenses, and Changes in Net Assets	25
<b>Report on Compliance with Laws and Regulations and Internal Control</b>	26-27

## Independent Auditor's Report

To the Board of Trustees  
John Tolfree Health System Corporation

We have audited the accompanying financial statements of the business-type activities and the aggregate discretely presented component units of John Tolfree Health System Corporation (a component unit of the City of West Branch) as of and for the years ended March 31, 2006 and 2005. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the business-type activities and the aggregate discretely presented component units of John Tolfree Health System Corporation at March 31, 2006 and 2005 and the respective changes in financial position and cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

In accordance with *Government Auditing Standards*, we have also issued our report dated May 10, 2006 on our consideration of John Tolfree Health System Corporation's internal control over financial reporting and on our tests of its compliance with certain provisions of laws, regulations, contracts, and grants. The purpose of that report is to describe the scope of our testing of internal control over financial reporting and compliance and the results of that testing, and not to provide an opinion on the internal control over financial reporting or on compliance. That report is an integral part of an audit performed in accordance with *Government Auditing Standards* and should be considered in assessing the results of our audit.

To the Board of Trustees  
John Tolfree Health System Corporation

The accompanying financial statements do not present a management's discussion and analysis, which would be an analysis of the financial performance for the year. The Governmental Accounting Standards Board has determine that this analysis is necessary to supplement, although not required to be part of, the basic financial statements.

*Plante & Moran, PLLC*

May 10, 2006

# John Tolfree Health System Corporation

## Balance Sheet

	March 31, 2006		March 31, 2005	
	Hospital	Component Units	Hospital	Component Units
<b>Assets</b>				
<b>Current Assets</b>				
Cash and cash equivalents (Note 2)	\$ 6,668,457	\$ 341,702	\$ 2,834,220	\$ 216,731
Accounts receivable (Note 3)	1,593,295	399,990	3,801,723	397,757
Due from affiliates	342,778	200	281,326	200
Estimated third-party payor settlements (Note 4)	180,188	-	771,562	-
Prepaid expenses and other	604,467	61,392	495,559	55,421
Inventory	1,080,417	-	1,112,043	-
Total current assets	10,469,602	803,284	9,296,433	670,109
<b>Assets Limited as to Use</b> (Note 2)	6,187,695	1,975,345	5,945,534	2,081,818
<b>Property and Equipment</b> (Note 5)	17,329,574	9,953,329	19,031,434	9,890,338
<b>Deferred Charges</b>	286,144	-	302,495	-
Total assets	<u><b>\$34,273,015</b></u>	<u><b>\$12,731,958</b></u>	<u><b>\$34,575,896</b></u>	<u><b>\$12,642,265</b></u>
<b>Liabilities and Net Assets</b>				
<b>Current Liabilities</b>				
Current portion of long-term debt (Note 6)	\$ 532,056	\$ 71,377	\$ 503,012	\$ 68,925
Due to affiliates	200	342,778	200	281,326
Accounts payable	2,365,709	64,403	1,999,343	69,182
Accrued liabilities	2,095,422	29,839	1,676,013	22,413
Total current liabilities	4,993,387	508,397	4,178,568	441,846
<b>Long-term Debt</b> (Note 6)	16,108,443	933,654	16,640,870	1,004,404
<b>Deferred Revenue</b> (Note 7)	-	3,876,569	-	3,993,450
Total liabilities	21,101,830	5,318,620	20,819,438	5,439,700
<b>Net Assets</b>				
Invested in capital assets - Net of related debt	689,075	8,948,298	1,887,552	8,817,009
Unrestricted	12,482,110	(1,534,960)	11,868,906	(1,614,444)
Total net assets	13,171,185	7,413,338	13,756,458	7,202,565
Total liabilities and net assets	<u><b>\$34,273,015</b></u>	<u><b>\$12,731,958</b></u>	<u><b>\$34,575,896</b></u>	<u><b>\$12,642,265</b></u>

# John Tolfree Health System Corporation

## Statement of Revenue, Expenses, and Changes in Net Assets

	Year Ended March 31			
	2006		2005	
	Hospital	Component Units	Hospital	Component Units
<b>Operating Revenue</b>				
Net patient service revenue	\$ 36,814,188	\$ 2,562,258	\$ 36,900,285	\$ 2,510,318
Other operating revenue	618,674	1,385,563	491,340	1,531,048
Total operating revenue	37,432,862	3,947,821	37,391,625	4,041,366
<b>Operating Expenses</b>				
Salaries and wages	12,989,640	1,045,842	12,491,357	1,090,800
Employee benefits and payroll taxes	4,528,556	382,324	4,318,710	374,400
Operating supplies and expenses	8,067,211	380,936	7,719,371	375,549
Medical supplies and drugs	3,253,425	81,566	4,599,301	105,150
Professional services and consultant fees	3,365,857	569,720	3,284,310	564,718
Depreciation and amortization	1,923,475	525,480	1,930,905	532,041
Other	3,279,657	866,266	3,222,210	721,278
Total operating expenses	37,407,821	3,852,134	37,566,164	3,763,936
<b>Operating Income (Loss)</b>	25,041	95,687	(174,539)	277,430
<b>Nonoperating Revenue (Expense)</b>				
Interest income	334,512	67,636	141,782	51,836
Contributions	9,330	79,552	12,898	77,704
Interest expense	(949,256)	(37,002)	(975,003)	(39,373)
Total nonoperating revenue (expense)	(605,414)	110,186	(820,323)	90,167
<b>Transfer from (to) Affiliate</b>	(4,900)	4,900	-	-
<b>Increase (Decrease) in Net Assets</b>	(585,273)	210,773	(994,862)	367,597
<b>Net Assets - Beginning of year</b>	13,756,458	7,202,565	14,751,320	6,834,968
<b>Net Assets - End of year</b>	<u>\$13,171,185</u>	<u>\$ 7,413,338</u>	<u>\$13,756,458</u>	<u>\$ 7,202,565</u>

# John Tolfree Health System Corporation

## Statement of Cash Flows

	Year Ended March 31			
	2006		2005	
	Hospital	Component Units	Hospital	Component Units
<b>Cash Flows from Operating Activities</b>				
Cash received from patients and third-party payors	\$ 39,613,990	\$ 2,560,025	\$ 36,823,619	\$ 2,624,357
Cash payments to suppliers for services and goods	(34,775,853)	(3,268,526)	(34,796,512)	(3,272,420)
Other receipts from operations	557,222	1,208,959	789,458	1,376,899
Net cash provided by operating activities	5,395,359	500,458	2,816,565	728,836
<b>Cash Flows from Noncapital Financing Activities - Donations and memorials</b>	9,330	139,275	12,898	114,971
<b>Cash Flows from Investing Activities</b>				
Interest received	334,512	67,636	141,782	51,836
Increase (decrease) in investments	(975,117)	(51,245)	(1,492,968)	469,692
Net cash provided by (used in) investing activities	(640,605)	16,391	(1,351,186)	521,528
<b>Cash Flows from Capital and Related Financing Activities</b>				
Acquisition and construction of capital assets	(210,164)	(583,571)	(812,310)	(981,395)
Interest paid on long-term debt	(949,256)	(37,002)	(975,003)	(39,373)
Principal payments on long-term debt	(503,383)	(68,298)	(479,069)	(65,927)
Net cash used in capital and related financing activities	(1,662,803)	(688,871)	(2,266,382)	(1,086,695)
<b>Net Increase (Decrease) in Cash and Cash Equivalents</b>	3,101,281	(32,747)	(788,105)	278,640
<b>Cash and Cash Equivalents - Beginning of year</b>	4,824,786	1,009,727	5,612,891	731,087
<b>Cash and Cash Equivalents - End of year</b>	<b>\$ 7,926,067</b>	<b>\$ 976,980</b>	<b>\$ 4,824,786</b>	<b>\$ 1,009,727</b>
<b>Composed of</b>				
Cash and cash equivalents	\$ 6,668,457	\$ 341,702	\$ 2,834,220	\$ 216,731
Assets limited as to use	1,257,610	635,278	1,990,566	792,996
Total	<b>\$ 7,926,067</b>	<b>\$ 976,980</b>	<b>\$ 4,824,786</b>	<b>\$ 1,009,727</b>



# John Tolfree Health System Corporation

## Statement of Cash Flows (Continued)

	Year Ended March 31			
	2006		2005	
	Hospital	Component Units	Hospital	Component Units
<b>Reconciliation of Operating Income (Loss) to Net Cash from Operating Activities</b>				
Operating income (loss)	\$ 25,041	\$ 95,687	\$ (174,539)	\$ 277,430
Adjustments to reconcile operating income (loss) to net cash from operating activities:				
Depreciation and amortization	1,923,475	525,480	1,930,905	532,041
Noncash rental income	-	(116,881)	-	(116,882)
Contributions included in operations	-	(59,723)	-	(37,267)
Provision for doubtful accounts	1,011,091	26,978	738,750	40,051
Changes in assets and liabilities:				
Patient accounts receivable	1,197,337	(29,211)	(676,254)	45,128
Due from affiliates	(61,452)	-	47,490	28,860
Third-party settlement receivable	591,374	-	(139,162)	-
Inventories	31,626	-	(107,508)	-
Other current assets	(108,908)	(5,971)	407,597	1,566
Accounts payable	323,753	(4,779)	576,920	3,408
Due from affiliates	42,613	61,452	(28,860)	(47,490)
Accrued expenses	419,409	7,426	241,226	1,991
Net cash provided by operating activities	<u>\$ 5,395,359</u>	<u>\$ 500,458</u>	<u>\$ 2,816,565</u>	<u>\$ 728,836</u>

During the years ended March 31, 2006 and 2005, the Corporation recognized revenue of \$116,881 and \$116,882, respectively, related to a deferred rental arrangement (see Note 7). The Hospital transferred \$4,900 of land to an entity with the component units.

# John Tolfree Health System Corporation

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## Notes to Financial Statements March 31, 2006 and 2005

### Note 1 - Nature of Business and Significant Accounting Policies

**Reporting Entity and Corporate Structure** - John Tolfree Health System Corporation (the "Hospital") provides inpatient and outpatient services primarily to the citizens of Ogemaw County and four adjacent counties. The Hospital is located in West Branch, Michigan. The Hospital is a municipal corporation whose board is appointed by the City Council of the City of West Branch. For this reason, the Hospital is considered to be a component unit of the City of West Branch (the "City") and is included as a discretely presented component unit in the basic financial statements of the City.

The Hospital is the sole member of three related entities: Medical Arts Center (the "Center"), Hospice of Helping Hands, Inc. (Hospice), and Tolfree Foundation (the "Foundation"). All are not-for-profit organizations or municipal corporations and are exempt from income taxes. The Center provides mammography, ultrasound, and cardiology services to area residents. Hospice provides home care services to the terminally ill. The Foundation engages in fund-raising activities on behalf of the Hospital.

**Basis of Presentation** - The financial statements include the accounts of John Tolfree Health System Corporation and its component units, Medical Arts Center, Hospice of Helping Hands, Inc., and Tolfree Foundation (collectively referred to as the "Corporation"). The financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America as prescribed by Governmental Accounting Standards Board (GASB) Statement No. 34, *Basic Financial Statements - and Management's Discussion and Analysis - for State and Local Governments*, issued in June 1999. The Corporation follows the "business-type" activities reporting requirements of GASB Statement No. 34 that provides a comprehensive look at the Corporation's financial activities. The Corporation has elected not to apply provisions of all pronouncement of the Financial Accounting Standards Board (FASB) issued after November 30, 1989.

**Proprietary Fund Accounting** - The Corporation utilizes the proprietary fund methods of accounting whereby revenue and expenses are recognized on the full accrual basis. Substantially all revenue and expense are subject to accrual.

**Cash and Cash Equivalents** - Cash and cash equivalents include cash and investments in highly liquid debt instruments with an original maturity of three months or less.

**Investments** - Investments are stated at market, plus accrued interest.

**Inventories** - Inventories are stated at lower of cost, determined by the first-in first-out method, or market.

**Assets Limited as to Use** - Assets limited as to use include assets set aside by the board of trustees for future capital improvements, over which the board retains control and may at its discretion subsequently use for other purposes, and assets held by trustees in accordance with debt arrangements.

# John Tolfree Health System Corporation

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## Notes to Financial Statements March 31, 2006 and 2005

### **Note 1 - Nature of Business and Significant Accounting Policies (Continued)**

**Property and Equipment** - Property and equipment acquisitions are recorded at cost. Donations of property and equipment are recorded at fair market value at the date of donation. Depreciation is computed on the straight-line basis over the estimated useful lives of the assets. Cost of maintenance and repairs are charged to expense when incurred.

**Deferred Charges** - Deferred charges represent bond issue costs that are being amortized over the period the respective bonds are outstanding using the interest method.

**Net Assets** - Net assets of the Corporation are classified in two components. Net assets invested in capital assets - net of related debt consists of capital assets net of accumulated depreciation and are reduced by the current balances of any outstanding borrowings used to finance the purchase or construction of those assets. Unrestricted net assets are the remaining net assets that do not meet the definition of invested in capital assets - net of related debt.

**Net Patient Service Revenue** - Net patient service revenue is reported at the estimated net realizable amounts from patients, third-party payors, and others for services rendered, including estimated retroactive adjustments under reimbursement agreements with third-party payors. Retroactively calculated adjustments arising under reimburse agreements with third-party payors are accrued on an estimated basis in the period the related services are rendered and adjusted in future periods as final settlements are determined (see Note 4).

Laws and regulations governing the Medicare and Medicaid programs are complex and subject to interpretation. Management believes that it is in compliance with all applicable laws and regulations. Final determination of compliance with such laws and regulations is subject to future government review and interpretation. Violations may result in significant regulatory action including fines, penalties, and exclusions from the Medicare and Medicaid programs.

**Statement of Revenue and Expenses** - For the purpose of display, transactions deemed by management to be ongoing, major, or central to the provision of health care services are reported as revenue and expenses. Peripheral or incidental transactions are reported as gains and losses.

**Compensated Absences** - Vacation and sick pay are charged to operations when earned. Unused and earned benefits are record as a current liability in the financial statements.

# John Tolfree Health System Corporation

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## Notes to Financial Statements March 31, 2006 and 2005

### **Note 1 - Nature of Business and Significant Accounting Policies (Continued)**

**Pension Plan** - The Corporation has a defined benefit pension plan covering all employees who work at least 1,000 hours a year after 30 months of service. The Corporation's funding policy is to contribute the amount necessary to provide assets sufficient to meet the benefits of plan participants, as determined by an independent actuary (see Note 8).

**Professional Liability Insurance** - The Corporation accrues the ultimate expense, including litigation and settlement expense, for incidents occurring during the year, as well as the estimate of those claims that have not been reported at year end (see Note 9).

**Charity Care** - The Corporation provides care to patients who meet certain criteria under its charity care policy without charge or at amounts less than established rates. Because the Corporation does not pursue collection of amounts determined to qualify as charity care, they are not reported as revenue. Charity care amounts to less than 1 percent of patients served.

**Tax Status** - The Corporation is tax-exempt under the Internal Revenue Code and, accordingly, no tax provision is reflected in the financial statements.

### **Note 2 - Deposits and Investments**

Michigan Compiled Laws Section 129.91 (Public Act 20 of 1943, as amended) authorizes local governmental units to make deposits and invest in the accounts of federally insured banks, credit unions, and savings and loan associations that have offices in Michigan. The local unit is allowed to invest in bonds, securities, and other direct obligations of the United States or any agency or instrumentality of the United States; repurchase agreements; bankers' acceptances of United States banks; commercial paper rated within the two highest classifications, which matures not more than 270 days after the date of purchase; obligations of the State of Michigan or its political subdivisions, which are rated as investment grade; and mutual funds composed of investment vehicles that are legal for direct investment by local units of government in Michigan.

#### **Hospital**

The Hospital has designated four banks for the deposit of its funds. The investment policy adopted by the board in accordance with Public Act 196 of 1997 has authorized investment in bonds and securities of the United States government and bank accounts and CDs, but not the remainder of State statutory authority as listed above. The Hospital is currently evaluating an investment in the American Hospital Association (AHA) Limited Maturity Fixed Income Fund to determine if it complies with Public Act 20 of 1943, as amended.

# **John Tolfree Health System Corporation**

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## **Notes to Financial Statements March 31, 2006 and 2005**

### **Note 2 - Deposits and Investments (Continued)**

The Hospital's cash and investments are subject to several types of risk, which are examined in more detail below:

#### **Custodial Credit Risk of Bank Deposits**

Custodial credit risk is the risk that in the event of a bank failure, the Hospital's deposits may not be returned to it. The Hospital does not have a specific deposit policy for custodial credit risk. At year end, the Hospital had approximately \$10,105,000 of bank deposits (certificates of deposit, checking, and savings accounts) that were uninsured and uncollateralized. The Hospital believes that due to the dollar amounts of cash deposits and the limits of FDIC insurance, it is impractical to insure all deposits. As a result, the Hospital evaluates each financial institution with which it deposits funds and assesses the level of risk of each institution; only those institutions with an acceptable estimated risk level are used as depositories.

#### **Credit Risk**

State law limits investments in commercial paper to the top two ratings issued by nationally recognized statistical rating organizations. The Hospital has no investment policy that would further limit its investment choices. At year end, the Hospital had \$1,056,282 invested in a mutual fund which invests in securities having one of the three highest ratings of either Moody's Investors Service or Standard & Poor's Corporation (at least A).

#### **Interest Rate Risk**

Interest rate risk is the risk that the value of investments will decrease as a result of a rise in interest rates. The Hospital's investment policy does not restrict investment maturities, other than commercial paper, which can only be purchased with a 270-day maturity. At year end, the Hospital had \$1,056,282 invested in a mutual fund which has a weighted average maturity of one to three years not to exceed five years.

#### **Component Units**

The component units have designated three banks for the deposit of its funds. The investment policy adopted by the board in accordance with Public Act 196 of 1997 has authorized investment in bonds and securities of the United States government and bank accounts and CDs, but not the remainder of State statutory authority as listed above. The component units deposits and investment policies are in accordance with statutory authority.

# John Tolfree Health System Corporation

## Notes to Financial Statements March 31, 2006 and 2005

### Note 2 - Deposits and Investments (Continued)

The component units' cash and investments are subject to custodial credit risk of bank deposits, which is examined in more detail below:

#### Custodial Credit Risk of Bank Deposits

Custodial credit risk is the risk that in the event of a bank failure, the component units' deposits may not be returned to them. The component units do not have a specific deposit policy for custodial credit risk. At year end, the component units had approximately \$1,547,000 of bank deposits (certificates of deposit, checking, and savings accounts) that were uninsured and uncollateralized. The component units believe that due to the dollar amounts of cash deposits and the limits of FDIC insurance, it is impractical to insure all deposits. As a result, the component units evaluate each financial institution with which they deposits funds and assess the level of risk of each institution; only those institutions with an acceptable estimated risk level are used as depositories.

### Note 3 - Accounts Receivable

The details of accounts receivable are set forth below:

	2006		2005	
	Hospital	Component Units	Hospital	Component Units
Patient accounts receivable	\$ 7,977,758	\$ 349,016	\$ 10,983,525	\$ 416,032
Less:				
Allowance for uncollectible accounts	(1,376,313)	(28,900)	(1,566,694)	(62,583)
Allowance for contractual adjustments	(5,107,643)	(55,891)	(6,206,636)	(75,710)
Net patient accounts receivable	1,493,802	264,225	3,210,195	277,739
Other	99,493	135,765	591,528	120,020
Total accounts receivable	\$ 1,593,295	\$ 399,990	\$ 3,801,723	\$ 397,757

Accounts receivable for patients, insurance companies, and governmental agencies are based on gross charges. An allowance for uncollectible accounts is established on an aggregate basis by using historical loss rate factors applied to unpaid accounts based on aging. Loss rate factors are based on historical loss experience and adjusted for economic conditions and other trends affecting the Corporation's ability to collect outstanding amounts. Uncollectible amounts are written off against the allowance for uncollectible accounts in the period they are deemed to be uncollectible. The allowance for contractual adjustments and interim payment advances is based on expected payment rates from payors using current reimbursement methodologies. This amount also includes amounts received as interim payments against unpaid claims by certain payors.

# John Tolfree Health System Corporation

## Notes to Financial Statements March 31, 2006 and 2005

### Note 3 - Accounts Receivable (Continued)

The Corporation grants credit without collateral to its patients, most of whom are local residents and are insured under third-party payor agreements.

The mix of receivables from patients and third-party payors was as follows:

	2006		2005	
	Hospital	Component Units	Hospital	Component Units
Medicare	37 %	52 %	39 %	33 %
Blue Cross	17 %	7 %	20 %	9 %
Medicaid	15 %	17 %	13 %	21 %
Commercial	19 %	6 %	17 %	19 %
Self-pay	12 %	18 %	11 %	18 %
Total	100 %	100 %	100 %	100 %

### Note 4 - Cost Report Settlements

The Corporation has agreements with third-party payors that provide for reimbursement to the Corporation at amounts different from its established rates. A summary of the basis of reimbursement is as follows:

- **Medicare** - Inpatient, acute-care services rendered to Medicare program beneficiaries are paid at prospectively determined rates per discharge. These rates vary according to a patient classification system based on clinical, diagnostic, and other factors. All outpatient services are paid based on an established fee-for-service methodology subject to hold-harmless provisions.
- **Medicaid** - Inpatient, acute-care services rendered to Medicaid program beneficiaries are also paid at prospectively determined rates per discharge. Capital costs relating to Medicaid patients are paid on a cost-reimbursement method. The Corporation is reimbursed for outpatient services on an established fee-for-service methodology.
- **Blue Cross** - Inpatient, acute-care services rendered to Blue Cross subscribers are also paid at prospectively determined rates per discharge. Outpatient services are reimbursed on an established fee-for-service methodology.

Cost report settlements result from the adjustment of interim payments to final reimbursement under these programs and are subject to audit by fiscal intermediaries. Although these audits may result in some changes in these amounts, they are not expected to have a material effect on the accompanying financial statements.

# John Tolfree Health System Corporation

## Notes to Financial Statements March 31, 2006 and 2005

### Note 5 - Property and Equipment

Capital asset activity for the Hospital for the year ended March 31, 2006 was as follows:

	Hospital					Depreciable Life - Years
	2005	Additions	Transfers	Retirements	2006	
Land and land improvements	\$ 569,425	\$ -	(4,900)	\$ -	\$ 564,525	5-25
Building	9,692,163	-	-	(3,439)	9,688,724	9-40
Equipment	17,423,038	193,606	7,446	(474,776)	17,149,314	3-25
Construction in progress	58,013	16,558	(7,446)	-	67,125	-
Total	27,742,639	210,164	(4,900)	(478,215)	27,469,688	
Less accumulated depreciation:						
Land and land improvements	212,842	38,508	-	-	251,350	
Building	1,702,473	284,163	-	(3,439)	1,983,197	
Equipment	6,795,890	1,584,453	-	(474,776)	7,905,567	
Total	8,711,205	1,907,124	-	(478,215)	10,140,114	
Net carrying amount	\$ 19,031,434	\$ (1,696,960)	\$ (4,900)	\$ -	\$ 17,329,574	



# John Tolfree Health System Corporation

## Notes to Financial Statements March 31, 2006 and 2005

### Note 5 - Property and Equipment (Continued)

Capital asset activity for the component units for the year ended March 31, 2006 was as follows:

	2005	Component Units				Depreciable Life - Years
		Additions	Transfers	Retirements	2006	
Land and land improvements	\$ 624,131	\$ 600	\$ 12,055	\$ -	\$ 636,786	5-25
Building	9,673,860	-	565,714	(17,950)	10,221,624	9-40
Equipment	2,307,931	43,462	489,645	(74,594)	2,766,444	3-25
Construction in progress	988,546	539,509	(1,062,514)	-	465,541	-
Total	13,594,468	583,571	4,900	(92,544)	14,090,395	
Less accumulated depreciation:						
Land and land improvements	74,787	15,324	-	-	90,111	
Building	2,483,862	321,261	-	(17,950)	2,787,173	
Equipment	1,145,481	188,895	-	(74,594)	1,259,782	
Total	3,704,130	525,480	-	(92,544)	4,137,066	
Net carrying amount	\$ 9,890,338	\$ 58,091	\$ 4,900	\$ -	\$ 9,953,329	

# John Tolfree Health System Corporation

## Notes to Financial Statements March 31, 2006 and 2005

### Note 5 - Property and Equipment (Continued)

Capital asset activity for the Hospital for the year ended March 31, 2005 was as follows:

	Hospital					Depreciable Life - Years
	2004	Additions	Transfers	Retirements	2005	
Land and land improvements	\$ 569,425	\$ -	-	\$ -	\$ 569,425	5-25
Building	9,692,163	-	-	-	9,692,163	9-40
Equipment	17,360,507	812,310	-	(749,779)	17,423,038	3-25
Construction in progress	58,013	-	-	-	58,013	-
Total	27,680,108	812,310	-	(749,779)	27,742,639	
Less accumulated depreciation:						
Land and land improvements	174,334	38,508	-	-	212,842	
Building	1,418,135	284,338	-	-	1,702,473	
Equipment	5,953,961	1,591,708	-	(749,779)	6,795,890	
Total	7,546,430	1,914,554	-	(749,779)	8,711,205	
Net carrying amount	\$ 20,133,678	\$ (1,102,244)	\$ -	\$ -	\$ 19,031,434	

# John Tolfree Health System Corporation

## Notes to Financial Statements March 31, 2006 and 2005

### Note 5 - Property and Equipment (Continued)

Capital asset activity for the component units for the year ended March 31, 2005 was as follows:

	Component Units					Depreciable Life - Years
	2004	Additions	Transfers	Retirements	2005	
Land and land improvements	\$ 626,681	\$ 2,200	\$ -	\$ (4,750)	\$ 624,131	5-25
Building	9,703,040	22,026	-	(51,206)	9,673,860	9-40
Equipment	2,507,127	11,221	-	(210,417)	2,307,931	3-25
Construction in progress	42,598	945,948	-	-	988,546	-
Total	12,879,446	981,395	-	(266,373)	13,594,468	
Less accumulated depreciation:						
Land and land improvements	64,272	15,265	-	(4,750)	74,787	
Building	2,220,945	314,123	-	(51,206)	2,483,862	
Equipment	1,153,245	202,653	-	(210,417)	1,145,481	
Total	3,438,462	532,041	-	(266,373)	3,704,130	
Net carrying amount	\$ 9,440,984	\$ 449,354	\$ -	\$ -	\$ 9,890,338	

Construction in progress at March 31, 2006 by the component units relates to the construction of a medical office building in a local area community. The total cost of this project is estimated to be \$1,700,000 and will be partially financed through a 20-year prepaid lease with another local health system. Under terms of this agreement, the other health system will prepay approximately 49.78 percent of the above construction costs in exchange for the prepaid lease. Remaining construction cost will be financed through internal funds.

# John Tolfree Health System Corporation

## Notes to Financial Statements March 31, 2006 and 2005

### Note 6 - Long-term Debt

Long-term debt activity for the year ended March 31, 2006 was as follows:

	Hospital				
	Beginning Balance	Current Year Additions	Current Year Reductions	Ending Balance	Current Portion
Bonds payable	\$ 13,610,000	\$ -	\$ (415,000)	\$ 13,195,000	\$ 440,000
Loan payable	3,533,882	-	(88,383)	3,445,499	92,056
Total	<u>\$ 17,143,882</u>	<u>\$ -</u>	<u>\$ (503,383)</u>	<u>\$ 16,640,499</u>	<u>\$ 532,056</u>

	Component Units				
	Beginning Balance	Current Year Additions	Current Year Reductions	Ending Balance	Current Portion
Note payable	<u>\$ 1,073,329</u>	<u>\$ -</u>	<u>\$ (68,298)</u>	<u>\$ 1,005,031</u>	<u>\$ 71,377</u>

Long-term debt activity for the year ended March 31, 2005 was as follows:

	Hospital				
	Beginning Balance	Current Year Additions	Current Year Reductions	Ending Balance	Current Portion
Bonds payable	\$ 14,005,000	\$ -	\$ (395,000)	\$ 13,610,000	\$ 415,000
Loan payable	3,617,951	-	(84,069)	3,533,882	88,012
Total	<u>\$ 17,622,951</u>	<u>\$ -</u>	<u>\$ (479,069)</u>	<u>\$ 17,143,882</u>	<u>\$ 503,012</u>

	Component Units				
	Beginning Balance	Current Year Additions	Current Year Reductions	Ending Balance	Current Portion
Note payable	<u>\$ 1,139,256</u>	<u>\$ -</u>	<u>\$ (65,927)</u>	<u>\$ 1,073,329</u>	<u>\$ 68,925</u>

- Bonds payable bear interest at fixed rates that vary from 5.45 percent to 6 percent. These bonds are collateralized by virtually all assets of the Hospital. The bonds are due in annual installments ranging from \$440,000 to \$1,145,000.
- The loan payable bears interest at fixed rate of 4.5 percent, is collateralized by virtually all assets of the Hospital and is due in monthly installments of \$20,467, including interest.
- The note payable to bank bears interest at a fixed rate of 3.5 percent and is collateralized by real estate of the Corporation. This loan is due in monthly installments of \$8,775 including interest. Any remaining balance is due in March 2008.

# John Tolfree Health System Corporation

## Notes to Financial Statements March 31, 2006 and 2005

### Note 6 - Long-term Debt (Continued)

In connection with the bond issues, the Corporation has agreed to various covenants. These covenants include restrictions on additional indebtedness, transfer of assets, and maintenance of certain financial ratios.

The following is a schedule of principal and interest payments as of March 31, 2006:

	Hospital		Component Units	
	Principal	Interest	Principal	Interest
2007	\$ 532,056	\$ 935,516	\$ 71,377	\$ 33,923
2008	551,285	907,308	933,654	31,384
2009	585,709	877,858	-	-
2010	620,335	844,860	-	-
2011	650,174	809,894	-	-
2012 - 2016	3,841,607	3,455,544	-	-
2017 - 2021	5,090,641	2,215,460	-	-
2022 - 2026	4,239,722	596,499	-	-
2027 and after	528,970	29,403	-	-
Total payments	<u>\$ 16,640,499</u>	<u>\$ 10,672,342</u>	<u>\$ 1,005,031</u>	<u>\$ 65,307</u>

### Note 7 - Deferred Revenue

Deferred revenue relates to a prepaid lease from an area hospital for partial use of a building attached to the Hospital. Under terms of the agreement, the lessee paid for a majority of the construction cost of the building, which the Corporation owns. In exchange, the Corporation issued a 40-year lease. Under terms of the lease agreement, the lessee makes no payments for rental of the building, although payments are made to the Corporation for certain operating costs of the building, such as housekeeping, utilities, and maintenance.

During the years ended March 31, 2006 and 2005, the Corporation recognized \$116,881 and \$116,882, respectively, in rental income.

### Note 8 - Pension Plan

**Plan Description** - The Corporation maintains a defined benefit retirement plan for all employees who work at least 1,000 hours per year after 30 months of service. Participants under the plan become fully vested after five years of credited service. The plan provides retirement benefits, as well as death and disability benefits. At April 1, 2005, the date of the most recent actuarial valuation, membership consisted of 35 retirees and beneficiaries currently receiving benefits and terminated employees entitled to benefits but not yet receiving them, and 271 current active employees. The plan does not issue a separate financial report.

# John Tolfree Health System Corporation

## Notes to Financial Statements March 31, 2006 and 2005

### Note 8 - Pension Plan (Continued)

**Funding Policy** - Plan member contributions are recognized in the period in which the contributions are due. Employer contributions to the plan are recognized when due and the employer has made a formal commitment to provide the contributions. Benefits and refunds are recognized when due and payable in accordance with the terms of the plan.

The funding policy provides for periodic employer contributions at actuarially determined rates. Administrative costs of the plan are financed through investment earnings. There are no employee contributions.

**Annual Pension Cost** - For the years ended March 31, 2006, 2005, and 2004, the Corporation's annual pension cost of \$697,951, \$792,953, and \$754,320, respectively, for the plan was equal to the Corporation's required and actual contribution. The annual required contribution was determined as part of an actuarial valuation of the plan as of April 1, 2005 using the entry age normal cost method. Significant actuarial assumptions used in determining the pension benefit obligation include: (a) a rate of return on the investment of present and future assets of 7 percent per year compounded annually as of April 1, 2005 and 2004 and (b) projected salary increases of 3.5 percent per year compounded annually as of April 1, 2005 and 2004. The unfunded actuarial liability is being amortized as a level percentage of payroll on an open and closed basis. The remaining amortization period is 21 years.

Three-year trend information:

	Year Ended March 31		
	2006	2005	2004
Annual pension cost	\$ 697,951	\$ 792,953	\$ 754,320
Percent of APC contributed	100 %	100 %	100 %
Actuarial value of assets	*	\$ 9,438,153	\$ 8,282,185
Actuarial accrued liability (entry age)	*	\$12,224,313	\$11,708,454
Unfunded AAL (UAAL)	*	\$ 2,786,160	\$ 3,426,269
Funded ratio	*	77 %	71 %
Covered payroll	*	\$ 9,932,688	\$ 9,748,321
UAAL as a percentage of covered payroll	*	28 %	35 %

\* Information not available

# John Tolfree Health System Corporation

## Notes to Financial Statements March 31, 2006 and 2005

### Note 9 - Risk Management

The Corporation is exposed to various risks of loss related to property loss, errors and omissions, employee injuries (workers' compensation), and professional liability claims, as well as medical benefits provided to employees. The Corporation has purchased commercial insurance for all of the above claims except for medical benefits provided to employees. For this benefit, the Corporation is self-insured and has purchased a stop-loss insurance policy to cover individual medical claims in excess of amount of \$75,000 in any one plan year. Settled claims relating to commercial insurance have not exceeded the amount of insurance in any of the past three years.

**Medical** - The Corporation estimates the liability for medical claims that have been incurred through the end of the fiscal year, including both claims that have been reported, as well as those that have not been reported. These estimates are recorded as a short-term liability.

	2006	2005
Estimated liability - Beginning of year	\$ 65,342	\$ 177,442
Estimated claims incurred, including changes in estimates	2,587,024	2,442,872
Claim payments	<u>(2,257,154)</u>	<u>(2,554,972)</u>
Estimated liability - End of year	<u>\$ 395,212</u>	<u>\$ 65,342</u>

**Malpractice** - The Corporation is insured against potential professional liability claims under a claims-made policy, whereby only the claims reported to the insurance carrier during the policy period are covered regardless of when the incident giving rise to the claim occurred. The Corporation bears the risk of the ultimate costs of any individual claims exceeding the policy limits for claims asserted in the policy year. For this contingency, the Corporation has accrued a liability of \$80,710 and \$60,865 at March 31, 2006 and 2005, respectively. The Corporation charged \$50,000 against operations during the years ended March 31, 2006 and 2005.

Should the claims-made policy not be renewed or replaced with equivalent insurance, claims based on occurrences during the claims-made term, but reported subsequently, will be uninsured.

The Hospital is named a co-defendant on a lawsuit alleging professional malpractice related to a newborn delivery that occurred in March 2002. This case was filed in April 2003; however, no trial date has been set. The Hospital believes it has valid defenses against this suit; however, there is a 50 percent chance that the ultimate resolution will result in a loss in excess of the Hospital's professional liability policy limit of \$1 million.

# John Tolfree Health System Corporation

## Notes to Financial Statements March 31, 2006 and 2005

### Note 10 - Component Unit Information

Condensed financial information by individual component unit is as follows:

	March 31, 2006			March 31, 2005		
	Medical Arts Center	Hospice of Helping Hands, Inc.	Tolfree Foundation	Medical Arts Center	Hospice of Helping Hands, Inc.	Tolfree Foundation
<b>Assets</b>						
Current assets	\$ 468,619	\$ 283,069	\$ 51,596	\$ 350,208	\$ 259,521	\$ 60,380
Assets limited as to use	624,229	-	1,351,116	801,899	-	1,279,919
Property and equipment	9,870,131	290	82,908	9,807,339	691	82,308
Total assets	<u>\$ 10,962,979</u>	<u>\$ 283,359</u>	<u>\$ 1,485,620</u>	<u>\$ 10,959,446</u>	<u>\$ 260,212</u>	<u>\$ 1,422,607</u>
<b>Liabilities</b>						
Current liabilities	\$ 356,726	\$ 144,806	\$ 6,865	\$ 266,377	\$ 161,861	\$ 13,608
Long-term debt	933,654	-	-	1,004,404	-	-
Deferred revenue	3,876,569	-	-	3,993,450	-	-
Total liabilities	5,166,949	144,806	6,865	5,264,231	161,861	13,608
<b>Net Assets</b>						
Invested in capital assets -						
Net of related debt	8,865,100	290	82,908	8,734,010	691	82,308
Unrestricted	(3,069,070)	138,263	1,395,847	(3,038,795)	97,660	1,326,691
Total net assets	<u>5,796,030</u>	<u>138,553</u>	<u>1,478,755</u>	<u>5,695,215</u>	<u>98,351</u>	<u>1,408,999</u>
Total liabilities and net assets	<u>\$ 10,962,979</u>	<u>\$ 283,359</u>	<u>\$ 1,485,620</u>	<u>\$ 10,959,446</u>	<u>\$ 260,212</u>	<u>\$ 1,422,607</u>
Year Ended						
	March 31, 2006			March 31, 2005		
	Medical Arts Center	Hospice of Helping Hands, Inc.	Tolfree Foundation	Medical Arts Center	Hospice of Helping Hands, Inc.	Tolfree Foundation
<b>Operating Revenue</b>	\$ 2,442,039	\$ 1,397,967	\$ 107,815	\$ 2,598,278	\$ 1,370,956	\$ 72,132
<b>Operating Expenses</b>	2,338,347	1,438,068	75,719	2,297,516	1,407,856	58,564
<b>Income (Loss)</b>	103,692	(40,101)	32,096	300,762	(36,900)	13,568
<b>Nonoperating Revenue (Expense)</b>	(7,777)	80,303	37,660	(23,447)	78,220	35,394
<b>Transfer from Affiliate</b>	4,900	-	-	-	-	-
<b>Increase in Net Assets</b>	<u>\$ 100,815</u>	<u>\$ 40,202</u>	<u>\$ 69,756</u>	<u>\$ 277,315</u>	<u>\$ 41,320</u>	<u>\$ 48,962</u>



## **Additional Information**

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To the Board of Trustees  
John Tolfree Health System Corporation

We have audited the basic financial statements of the business-type activities and the aggregate discretely presented component units of John Tolfree Health System Corporation for the years ended March 31, 2006 and 2005. Our audits were made for the purpose of forming an opinion on the basic financial statements taken as a whole. The combining information is presented for the purpose of additional analysis of the basic financial statements rather than to present the financial position, results of operation, and cash flows of the individual entities. The information has been subjected to the procedures applied in the audits of the basic financial statements and, in our opinion, is fairly stated in all material respects in relation to the financial statements taken as a whole.

*Plante & Moran, PLLC*

May 10, 2006

# John Tolfree Health System Corporation

## Combining Balance Sheet March 31, 2006

	Hospital	Medical Arts Center	Hospice of Helping Hands, Inc.	Tolfree Foundation	Eliminating Entries	Total
<b>Assets</b>						
<b>Current Assets</b>						
Cash and cash equivalents	\$ 6,668,457	\$ 193,881	\$ 113,423	\$ 34,398	\$ -	\$ 7,010,159
Accounts receivable	1,593,295	234,199	165,791	-	-	1,993,285
Due from affiliates	342,778	200	-	-	-	342,978
Estimated third-party payor settlements	180,188	-	-	-	-	180,188
Prepaid expenses and other	604,467	40,339	3,855	17,198	-	665,859
Inventory	1,080,417	-	-	-	-	1,080,417
Total current assets	10,469,602	468,619	283,069	51,596	-	11,272,886
<b>Assets Limited as to Use</b>						
Property and Equipment	6,187,695	624,229	-	1,351,116	-	8,163,040
Deferred Charges	17,329,574	9,870,131	290	82,908	-	27,282,903
	286,144	-	-	-	-	286,144
Total assets	<b>\$ 34,273,015</b>	<b>\$ 10,962,979</b>	<b>\$ 283,359</b>	<b>\$ 1,485,620</b>	<b>\$ -</b>	<b>\$ 47,004,973</b>
<b>Liabilities and Net Assets</b>						
<b>Current Liabilities</b>						
Current portion of long-term debt	\$ 532,056	\$ 71,377	\$ -	\$ -	\$ -	\$ 603,433
Due to affiliates	200	249,130	86,783	6,865	-	342,978
Accounts payable	2,365,709	36,219	28,184	-	-	2,430,112
Accrued liabilities	2,095,422	-	29,839	-	-	2,125,261
Total current liabilities	4,993,387	356,726	144,806	6,865	-	5,501,784
<b>Long-term Debt</b>	16,108,443	933,654	-	-	-	17,042,097
<b>Deferred Revenue</b>	-	3,876,569	-	-	-	3,876,569
Total liabilities	21,101,830	5,166,949	144,806	6,865	-	26,420,450
<b>Net Assets</b>						
Invested in capital assets - Net of related debt	689,075	8,865,100	290	82,908	-	9,637,373
Unrestricted	12,482,110	(3,069,070)	138,263	1,395,847	-	10,947,150
Total net assets	13,171,185	5,796,030	138,553	1,478,755	-	20,584,523
Total liabilities and net assets	<b>\$ 34,273,015</b>	<b>\$ 10,962,979</b>	<b>\$ 283,359</b>	<b>\$ 1,485,620</b>	<b>\$ -</b>	<b>\$ 47,004,973</b>

# John Tolfree Health System Corporation

## Combining Statement of Revenue, Expenses, and Changes in Net Assets Year Ended March 31, 2006

	Hospital	Medical Arts Center	Hospice of Helping Hands, Inc.	Tolfree Foundation	Eliminations	Total
<b>Operating Revenue</b>						
Net patient service revenue	\$ 36,814,188	\$ 1,164,291	\$ 1,397,967	\$ -	\$ (391,015)	\$ 38,985,431
Other operating revenue	618,674	1,277,748	-	107,815	(313,043)	1,691,194
Total operating revenue	37,432,862	2,442,039	1,397,967	107,815	(704,058)	40,676,625
<b>Operating Expenses</b>						
Salaries and wages	12,989,640	575,502	449,154	21,186	-	14,035,482
Employee benefits and payroll taxes	4,528,556	209,828	164,772	7,724	-	4,910,880
Operating supplies and expenses	8,067,211	296,129	63,234	21,573	-	8,448,147
Medical supplies and drugs	3,253,425	-	81,566	-	-	3,334,991
Professional services and consultant fees	3,365,857	470,834	98,886	-	(391,015)	3,544,562
Depreciation and amortization	1,923,475	525,079	401	-	-	2,448,955
Other	3,279,657	260,975	580,055	25,236	(313,043)	3,832,880
Total operating expenses	37,407,821	2,338,347	1,438,068	75,719	(704,058)	40,555,897
<b>Operating Income (Loss)</b>	25,041	103,692	(40,101)	32,096	-	120,728
<b>Nonoperating Revenue (Expense)</b>						
Interest income	334,512	29,225	751	37,660	-	402,148
Contributions	9,330	-	79,552	-	-	88,882
Interest expense	(949,256)	(37,002)	-	-	-	(986,258)
Total nonoperating revenue (expense)	(605,414)	(7,777)	80,303	37,660	-	(495,228)
<b>Transfer from (to) Affiliate</b>	(4,900)	4,900	-	-	-	-
<b>Increase (Decrease) in Net Assets</b>	(585,273)	100,815	40,202	69,756	-	(374,500)
<b>Net Assets - Beginning of year</b>	13,756,458	5,695,215	98,351	1,408,999	-	20,959,023
<b>Net Assets - End of year</b>	<b>\$ 13,171,185</b>	<b>\$ 5,796,030</b>	<b>\$ 138,553</b>	<b>\$ 1,478,755</b>	<b>\$ -</b>	<b>\$ 20,584,523</b>

## **Report on Compliance with Laws and Regulations and Internal Control**

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To the Board of Trustees  
John Tolfree Health System Corporation

We have audited the financial statements of John Tolfree Health System Corporation as of and for the year March 31, 2006 and have issued our report thereon dated May 10, 2006. We conducted our audit in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States.

### Compliance

As part of obtaining reasonable assurance about whether John Tolfree Health System Corporation's financial statements are free of material misstatement, we performed tests of its compliance with certain provisions of laws, regulations, contracts, and grants, noncompliance with which could have a direct and material effect on the determination of financial statement amounts. However, providing an opinion on compliance with those provisions was not an objective of our audit and, accordingly, we do not express such an opinion. The results of our tests disclosed no instances of noncompliance that are required to be reported under *Government Auditing Standards*.

### Internal Control Over Financial Reporting

In planning and performing our audit, we considered John Tolfree Health System Corporation's internal control over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. Our consideration of the internal control over financial reporting would not necessarily disclose all matters in the internal control over financial reporting that might be material weaknesses. A material weakness is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

We noted no matters involving the internal control over financial reporting and its operation that we consider to be material weaknesses. However, we noted other matters involving the internal control over financial reporting that we have reported to the management of John Tolfree Health System Corporation in a separate letter dated May 10, 2006.

This report is intended solely for the information and use of the board of trustees, management, and federal awarding agencies and is not intended to be, and should not be, used by anyone other than these specified parties.

*Plante & Moran, PLLC*

May 10, 2006

May 10, 2006

To the Board of Trustees  
John Tolfree Health System Corporation

In planning and performing our audit of the financial statements of John Tolfree Health System Corporation (the "Corporation") for the year ended March 31, 2006, we considered the Corporation's internal control in order to determine our auditing procedures for the purpose of expressing our opinion on the combined financial statements and not to provide assurance on the internal control. However, we noted certain matters involving the internal control and its operation that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or operation of the internal control that, in our judgment, could adversely affect the Corporation's ability to record, process, summarize, and report financial data consistent with the assertions of management in the combined financial statements. This letter includes a reportable condition as well as other comments and recommendations for your consideration.

### **REPORTABLE CONDITION**

#### **Legal Investments under Public Act 20 of 1943**

During our testing of investments, we noted the Corporation is invested in a mutual fund that has holdings which may not be allowable under Public Act 20 of 1943. We would strongly encourage the Corporation to review all current investments to determine if they comply with Public Act 20 of 1943.

### **OTHER ITEMS**

#### **Vacation Accrual**

During our review of the vacation accrual, it was noted that the computer system does not properly accommodate the Corporation's vacation policy. Due to this non-accommodation by the system, the Corporation has to manually calculate the six month anniversary vacation earnings for each employee. This process is time consuming and could potentially lead to errors in the computation of accrued vacation time.

We recommend the Corporation create the necessary system reports that can be downloaded to an electronic spreadsheet and set up to automatically calculate the vacation accrual based on the policy of the Corporation.

**Bad Debt Write-offs**

During our testing of contractual allowances, it was noted that the Corporation had a substantial amount of Medicare bad debts disallowed related to an audit of the March 31, 2004 Medicare cost report. After review of the workpapers submitted to Medicare, it was apparent that a portion of this loss was due to certain amounts on the bad debt listing that are not allowable under the Medicare system. Another contributory factor for the disallowed bad debts was due to the Medicare auditors not fully understanding the Medicare/Medicaid secondary system.

We recommend the Corporation review the 2004 through 2006 bad debt write-off listings for accuracy and make the necessary changes. There is a potential to reopen the 2004 Medicare cost report and recover a portion of the disallowed bad debts.

**GASB Update**

GASB Statement No. 45 provides guidance for local units of government in recognizing the cost of retiree healthcare, as well as any "other" postemployment benefits (other than pensions). The intent of the new rules is to recognize the cost of providing retiree healthcare coverage over the working life of the employee, rather than at the time the healthcare premiums are paid.

The new pronouncement will require a valuation of the obligation to provide retiree healthcare benefits, including an amortization of the past service cost over a period of up to 30 years. The valuation must include an annual recommended contribution (ARC). While the ARC does not need to be funded each year, any under funding must be reported as a liability on the statement of net assets.

This valuation will need to be performed by an actuary if the total participants exceed 100. Participants are defined as employees in active service, terminated employees not yet receiving benefits, plus retirees and beneficiaries currently receiving benefits. For plans with 100 to 200 participants, the actuarial valuation must be at least every three years; for those over 200 participants, at least every other year.

This statement will be effective for the year ended March 31, 2009. The planning to make the ARC generally requires from three to six months for an actuarial valuation, plus six months lead time to work the numbers into the budget. Therefore, we recommend that you begin the actuarial valuation at least one year prior to the above date.

**2006 OIG Work Plan**

The 2006 Work Plan issued by the Office of the Inspector General (OIG) identifies projects that have evolved in response to new issues and the shifting priorities of Congress. OIG spends significant resources in the investigation of fraud and misconduct committed against the Medicare and Medicaid programs.



Highlights from the OIG's 2006 Work Plan include, but are not limited to:

**Rebates Paid to Hospitals** – OIG will determine whether hospitals are properly identifying purchase credits as a separate line item in their Medicare cost reports. This will be done through visiting several large vendors and determining the amount of rebates paid to hospitals in a given year, and then examining a sample of cost reports to determine if the rebates were properly credited.

**Coronary Artery Stents** – OIG will review inpatient and outpatient claims involving arterial stent implantation to determine whether Medicare payments for these services were appropriate. This will be done through medical reviews to determine if the services were medically necessary and supported by adequate documentation. They will also review claims for beneficiaries who had stent implantations during multiple surgical procedures to determine if the implantations should have been performed simultaneously.

**Outpatient Department Payments** – OIG will review payments to hospital outpatient departments under the prospective payment system to determine the extent to which they were made in accordance with Medicare laws and regulations. They will review the appropriateness of payments made for multiple procedures, repeat procedures, and global surgeries.

**Unbundling of Hospital Outpatient Services** – OIG will determine the extent to which hospitals and other providers are submitting claims for services that should be bundled into outpatient services.

**"Inpatient Only" Services Performed in an Outpatient Setting** – OIG will determine if Medicare payments are appropriately denied for "inpatient only" and related services performed in an outpatient setting and assess the extent to which Medicare beneficiaries are held liable for denied inpatient claims for those services. They will also assess whether CMS computer edits required to implement the outpatient prospective payment system were implemented.

**Diagnosis-Related Group Coding** – OIG will examine DRG codes to determine whether some acute care hospitals exhibit aberrant coding patterns. Under the PPS, DRGs for inpatient acute care depend on accurate coding of diagnoses and procedures.

**Physicians - Billing Service Companies** – OIG will review the relationship between billing companies and physicians and other Medicare providers to determine the impact of these arrangements on physicians' billings.

**Physicians - Payments to Providers for Initial Preventative Physical Examination** – Section 611 of the Medicare Modernization Act (MMA) provides for coverage of an initial preventative physical examination (IPPE) which includes an EKG, measurements of height, weight, blood pressure, review of medical and social history, assessment of depression, and evaluation of functioning ability for new Medicare beneficiaries effective January 1, 2005. OIG will be evaluating the billing practices to ensure physicians are not claiming higher payment for services they performed in the past with existing patients but new Medicare beneficiaries.

This report is intended solely for the information and use of the Board of Trustees, management, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties.

Very truly yours,

**PLANTE & MORAN, PLLC**

A handwritten signature in black ink, appearing to be 'M. Baker', with a long horizontal flourish extending to the right.

Michael A. Baker, CPA  
Partner